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ABSTRACT

Part of a series of classroom aids designed for real estate instructors, this instructional packet was developed to help real estate students understand the opportunities and pitfalls associated with investments in undeveloped land, and ways to reduce the risk of ownership. A summary instructor's presentation is provided, which: (1) defines undeveloped land as "acreage having the potential of being subdivided within 15 years or so"; (2) discusses the characteristics which make investing in undeveloped land attractive; (3) explains the forces affecting the value of the land; (4) points to potential risks; (5) examines factors to be considered when buying and selling; (6) recommends that professional advisors be consulted; (7) discusses ways of packaging the investment; (8) reviews practices related to broker commissions; and (9) offers advice on precautions that landowners should take. A selected glossary, a series of overhead masters keyed to the text, and an evaluation form conclude the packet. (EJV)

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TEACHERS INSTRUCTIONAL PACKET
TIP No. 9, Spring 1986

INVESTING IN UNDEVELOPED LAND

Texas Real Estate Research Center
College of Agriculture
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College Station, Texas 77843-2115

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TIPS on the TIP

This Teacher Instructional Packet (TIP) is designed to provide the real estate instructor with classroom aids. Packets have been reviewed carefully, but there is always room for improvement. Suggestions to improve the usefulness of the TIP are welcomed.

Introduction to the TIP

TIP-9 has been developed to help students understand investing in undeveloped land in Texas. This material is provided as a **supplement** to existing course content. It is not a pat presentation. Instructors may use as much or as little as needed.

NOTE: Copies of the TRERC Technical Report, "Investing in Undeveloped Land," have been provided to Texas real estate instructors. Additional copies are available for $1 each ($2 for out-of-state orders). Ask for publication number 353. Instructors have permission to reproduce this report in full or in part providing no changes are made in the content.

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INVESTING IN UNDEVELOPED LAND

This summary reviews the opportunities and pitfalls associated with investment in undeveloped land and offers suggestions for reducing the risk of ownership.

What Is Undeveloped Land?

Undeveloped land is described here as acreage having the potential of being subdivided within 15 or so years. Undeveloped land, although perhaps being farmed, differs from farms and ranches because of its potential for development.

It is helpful to think of undeveloped or underdeveloped land as undergoing a use-transition period. Development is expected in the foreseeable future. The purchaser hopes to benefit financially during this transition period by buying at or just above agricultural land prices and selling at a predevelopment price.

Attractive Characteristics

Land is tangible and immobile. It can satisfy certain human needs and is

scarce in many areas. Therefore, land has desirable investment characteristics. Value is enhanced by (1) real appreciation and inflationary gains, (2) the possibility of receiving income from rents and (3) income-tax deductions for business expenses, real estate taxes and, within limits, interest. Undeveloped land offers the opportunity for favorable capital gains tax rates on resale. Ownership provides a monopoly on a specific location, and gains can be magnified through financial leverage.

VISUAL #1

Land Value

Gain realized on resale is the primary motivation behind most undeveloped land investments. Two of the main avenues of gain are local growth and inflation.

As a city and its suburbs grow, transportation arteries are built to accommodate existing and future demand. Land once considered too distant from the city for anything except agricultural purposes becomes sought for its development potential.

Because it is tangible, indestructible and useful, undeveloped land is considered an excellent hedge against inflation.

Leverage -- the ability to borrow -- can enhance capital gains from land. Few institutional lenders are willing to lend with raw land as collateral. In most situations, however, owners must finance the property they sell; down payments typically range from 10 to 40 percent with the balance financed from 5 to 20 years, and interest rates sometimes are less than those available from third parties.

Leverage is a two-edged sword. Unless the property appreciates at a rate above the interest rate paid for borrowed money, the equity erodes. Such conditions generally result in abandonment or foreclosure.

VISUAL #2

Leverage

Release provisions, whereby portions of the property are deeded free and clear to the purchaser on payment of part of the principal owed, are common.

Cash returns during ownership of undeveloped land seldom are significant.

Some arable parcels are rented, but such rent seldom brings more than 5 percent of market value. Rent may pay the taxes, but rarely is there a cash flow. Income-tax deductions reduce the net carrying costs of undeveloped land.

With undeveloped land, the asset is safe. Land cannot be lost or stolen, although it is subject to erosion, adverse possession and political upheaval. Environmental restrictions may reduce or retard value. Generally, land is solid security.

Land ownership provides intangible benefits as well. Land provides safety, security and pride of ownership. Once developed, the land provides a sense of artistic accomplishment.

Land is attractive to investors because of its potential for appreciation. It provides an inflation hedge because it is tangible, indestructible and useful. Use of borrowed money can enhance returns from an equity investment, and most expenses paid are tax deductible. Although

annual cash returns from land investments may be negative, the appreciation realized at resale can be substantial.

Forces Affecting Value

Forces that affect the value of undeveloped land fall into four categories: physical, economic, governmental and sociological.

VISUAL #3
Forces Affecting Value

Physical forces include the size and shape of the parcel, topography, vegetation, soil and subsoil conditions. The size and shape must be adequate for development.

VISUAL #4
Physical Forces

Economic factors are at work on the national, regional, state and local levels. These include employment, economic base, income and price levels, interest rates and inflation. The rationale of buying undeveloped land is based on growth potential.

VISUAL #5
Economic Factors

Growing incomes and rising per capita or family income are desirable. Investing in land located in a declining income region is unwise unless the land can be acquired at an extremely depressed price.

High interest rates tend to depress the price of non-income-producing land. Investors put their money elsewhere. If the high interest rates are symptoms of anticipated high inflation, land prices will rise along with other tangibles. Land buyers should be prepared to ride out the storms created by fluctuating interest rates.

Governmental factors include utilities, services, taxes, building codes and environmental regulations. The location of municipal or school district boundaries can sharply affect prices as well. Because utilities are essential to development, land investors should be reasonably certain that someday they will be available to the property.

VISUAL #6

Governmental Factors

Investors must be aware of those local governments that have adopted no-growth policies. A land investor must have great fortitude to buy undeveloped land in such areas or where similar policies might be implemented.

VISUAL #7

Sociological Factors

Sociological factors include demographics, attitudes and tastes. The land's investment value depends on whether or not people want to use it. Demographics include the population of an area -- natural increases and in-migration, household and family size, age and sex composition, ethnic background, density and geographical distribution.

Tastes and attitudes also are important. A preference for high- or low-density housing, for example, may depend on one's background, the climate of the area and transportation facilities.

Physical, economic, governmental and sociological factors all affect the value of real estate. There is no such thing as a physically perfect piece of land, but some parcels will need much more effort for use.

Potential Risks

Rates of return from underdeveloped land investments will vary widely. Land investments are not like high-grade bonds that offer income with a high

degree of certainty and a yield-to-maturity that can be measured precisely. Land is subject to many risks, some of which are described next.

VISUAL #8
Risks

Illiquidity is the great nemesis of land investors. Many other investments can be sold at market value on short notice, but it is time consuming to parcel out or subdivide land into undivided interests. Land may require several months or years on the market for the owner to realize its market value.

Regulatory and political risks also are present. A governmental agency enforcing environmental regulations can cause expensive development delays and prevent development of the land to its highest and best use.

Private ownership is subject to the government's right of eminent domain. Landowners sometimes feel condemnation awards are insufficient.

Markets for undeveloped land generally are local ones. They are subject to influences at all levels of the government and economy, particularly

the local area. Stability is the general rule, but wide swings can occur for specific property. After a local recession, economic activity resumes and land prices continue to ratchet upward, so a trough in prices goes virtually unnoticed.

Factors When Buying and Selling

The most important factors when buying and selling are: (1) selecting a broker, (2) finding the right market, (3) judging the quality of properties, (4) use of professional advisors, (5) negotiating the purchase or sales price and (6) terms of sale and negotiating acceptable financing terms.

VISUAL #9

Factors When Buying and Selling

When selecting a broker, it is important to find a local person knowledgeable about land -- its physical, economic, governmental and social environment.

Reputations of land salespersons are crucial. Honesty and knowledge are invaluable. Lawyers, certified public accountants, bankers and other professionals often can recommend a good land salesperson. Real estate

salespersons, appraisers and developers also are good sources.

One should approach land buying in a disciplined and systematic manner. There are two types of approaches. One is to find the specific site you want and negotiate with the owner. The other is to select from what is offered on the market.

Sellers will quote an offering price through their brokers. Negotiation is customary in real estate, and buyers generally will submit an offer through the broker for a low amount and generous financing terms. The owner may accept the offer or reject it with or without a counter offer. Negotiations continue until broken off or agreement is reached. Providing all conditions of the contract have been met, closing takes place. Money and property change hands.

Professional Advisors

Brokers, appraisers, attorneys, planning consultants and accountants are professionals commonly used by land

VISUAL #10

Advisors

buyers or sellers. Depending on the complexity of the property and the transaction, others can be helpful. These include farm, ranch or timber specialists, counselors, mortgage bankers, architects and engineers.

Seek out a professional familiar with the type of transaction involved.

Packaging the Investment

The greatest increment of profit occurs with the recognition of a parcel's highest and best use. This is not necessarily its actual use. A land investor might commission a detailed field-checked topographic study, hydrological analysis, subdivision lot layout or other land-use plan, zoning approval, water-sewer layout approval and perhaps soil borings and building permits. (As long as the land is not graded or otherwise physically disturbed, the investor should retain capital gains tax treatment.) This professional pre-developed work generally is termed packaging; it means getting raw land into a market-ready condition. Skilled landowners will begin planning the

ultimate sale of a property as soon as it is first acquired.

Broker Commissions

Real estate brokers are usually agents for the sellers and are paid by them. Commission rates on land range from 3 to 10 percent and are negotiable. Some brokers are amenable to deferring a part of the commission when the seller finances part of the sale.

Ownership Precautions

Periodic physical inspections of the land, liability insurance and tax payments are mandatory for land owners. Although the land itself cannot be destroyed, it is subject to the forces of humans and nature -- erosion, fire, pests, flooding, waste dumping, encroachments, squatters and theft of timber or minerals. Conduct an inspection of the property at least once a year.

VISUAL #11

Precautions

Liability insurance is recommended to protect against events such as an accidental drowning on the property.

Although such events are rare, liability insurance is particularly necessary when the land is used for recreational purposes.

Tax assessors should be notified of address changes, and the owner should be certain that taxes and other assessments are paid. Foreign investors should correspond with a knowledgeable person in the United States and file the necessary documents.

Summary

Financial and psychological rewards are available from investing in undeveloped land. Gains through appreciation provide rewards that can be magnified by financial leverage. However, the risks also are great, and few investors are really suited to assume these risks.

Selecting the right property and professional advisors is crucial. Investors should investigate the physical, economic, governmental and sociological forces affecting the land. Considerations must be given to financing and income taxes. Thus,

professional advice is helpful.

Undeveloped land often is compared to a mousetrap -- easy to get into but difficult to get out of. Consequently, <u>investors should be especially careful when buying land</u>.

VISUAL #12

Exercise Care

SELECTED GLOSSARY

acre: a measure of land containing 43,560 square feet

highest and best use: the legally permitted and otherwise feasible use of the land that will bring the greatest income or value to the land

leverage: use of others' money to complete an investment transaction

listing: an agreement to engage a broker to sell or lease

nonrecourse: the lender may claim only the property as collateral; the borrower is not personally liable

purchase money mortgage: a loan from the seller to the buyer of the property

release provisions: a clause in a mortgage that allows some property to be freed as collateral.

Land Value

- Real appreciation, inflationary gains
  - Income from rents
  - Income-tax deductions
- Favorable capital gains tax rate on resale
  - Gains magnified by leverage

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Visual No. 1

Leverage

- Appreciation = gain
- Depreciation = loss

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Visual No. 2

Forces Affecting Value

- Physical
- Economic
- Governmental
- Sociological

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Visual No. 3

Physical Forces

- Parcel size and shape
  - Topography
  - Vegetation
- Soil and subsoil

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Visual No. 4

Economic Factors

- Employment
- Economic base
- Income and price levels
- Interest rates
- Inflation

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Visual No. 5

Governmental Factors

- Utilities
- Services
- Taxes
- Building codes
- Environmental regulations

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Visual No. 6

Sociological Factors

- Demographics
- Attitudes
- Tastes

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Visual No. 7

Risks

- Illiquidity
- Regulatory and political
- Eminent domain

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Visual No. 8

Factors When Buying and Selling

- Broker selection
- Finding the right market
- Judging quality
- Using professional advisors
- Negotiating
- Terms of sale

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Visual No. 9

Advisors

- Brokers
- Appraisers
- Attorneys
- Planning consultants
- Accountants

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Visual No. 10

Precautions

- Physical inspections
- Liability insurance
- Tax payments

Texas Real Estate Research Center
Visual No. 11

Exercise Care

- Be careful when buying land

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Visual No. 12

INSTRUCTORS EVALUATION

In order for the Texas Real Estate Research Center to be able to better assess the effectiveness of this packet, your input is requested. Please complete this form and return it to the address provided.

CONCEPT

1. What overall rating would you give this concept?

useless 1 2 3 4 5 6 7 8 9 10 invaluable

RATING THE ELEMENTS

2. How do you rate the elements of this TIP?

Content:

too general 1 2 3 4 5 6 7 8 9 10 too technical

Amount of material:

too little 1 2 3 4 5 6 7 8 9 10 too much

Format:

too simple 1 2 3 4 5 6 7 8 9 10 too complex

STRENGTHS AND WEAKNESSES

3. What were the strengths of the package? _____

_____

_____

_____

4. What were the weaknesses of the package? _____

_____

_____

_____

SUGGESTIONS

5. What specific changes would you like to see in future TIPs?

_____

_____

6. What additional topics would you suggest for the TIP series?

a. _____ c. _____

b. _____ d. _____

EXPECTED USE

7. Do you expect using this packet in the next three months?

_____ yes _____ no

8. If you answered "yes" to question 7, to what classes will this material be presented?

_____

_____

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